ARCAPITA

Arcapita Point of View

Will the US Economy Face a Recession in 2019?

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Summary

- The US economy is unlikely to enter into a recession during the next two years, barring a major asset price correction.
- Fundamental economic indicators generally paint a positive picture of the US economy.
- Assets are likely overvalued but the effect of a negative correction on the economy should be limited, due to lower levels of private debt and greater financial oversight.
- The biggest proximate threat to the economy is the US-China trade dispute.
- President Donald Trump has a variety of political tools at his disposal to stimulate the economy over the course of the next two years, and his quest for a second term gives him a strong incentive to use them.

Basic Principles

Recessions can be caused by a variety of factors, some of which are more difficult to predict than others

Analysts are currently considering the likelihood of two possible developments for 2019: a significant slowdown in the rate of economic growth; and the start of a recession, which is defined as two consecutive quarters of economic contraction. Experts use a range of indicators to predict the likelihood of a recession. Before describing those indicators, it is worth explaining why a certain class of recession – the one caused by falling asset prices – is so difficult to predict.

Overvalued asset prices are a primary cause of recessions, such as the dot.com crash in 2001. When assets are overvalued, they create a false sense of optimism in the economy due to the importance of balance sheets to consumption and investment decisions, which in turn leads to over-spending and over-commitment of resources. Once the asset bubble bursts, and prices sharply decline, consumer and investor spending has to concomitantly retreat, generating a recession.

These kinds of recessions are historically difficult to predict, because asset prices are almost impossible to predict. The value of important assets, such as stocks and commodities, loosely follows what statisticians refer to as a "random walk", meaning that the best prediction of tomorrow's price is today's price. To see why, imagine that the market was confident that tomorrow's price would be higher: in that case, investors would buy shares today, anticipating a return tomorrow, leading to an immediate increase in share prices. This is known as the Efficient Market Hypothesis in economics, and while it does not work perfectly in practice, it implies that if you are reading a prediction of a bubble bursting imminently in the newspaper, it is most likely not to burst. Making accurate predictions in the stock market requires the person making the prediction to keep that prediction secret, as making it public leads to the entire market changing its behavior. The global financial crisis of 2008 was primarily an asset-price-induced recession, and this is what made it so difficult to anticipate.

However, recessions caused by other factors can be more accurately predicted and in this case experts use a variety of indicators.

The first class of indicators are those that measure the volume of economic activity, such as GDP, corporate profits, and employment. When the growth rate of these activities declines, or even turns negative, that acts as a warning sign.

The second class of indicators relates to asset prices. When the price of assets such as shares or houses declines sharply, that indicates an elevated risk of recession. When investors sell off these relatively risky assets, they usually buy safer assets such as long-term government bonds, making falling long-term bond yields an equivalent indicator of recession.

Basic Principles

The third class of indicators covers direct measures of confidence in the economy. These high frequency surveys ask consumers, producers, and investors how optimistic they are about the future. Negative sentiment usually precedes a recession.

There are no exact formulae linking these indicators to recessions. Each recession is unique in terms of its causes and characteristics, including the behavior of the aforementioned indicators in the period immediately preceding it. And, as mentioned above, in the case of recessions caused by asset-price crashes, such as the 2008 global financial crisis, they can be very difficult to predict based on publicly available information.

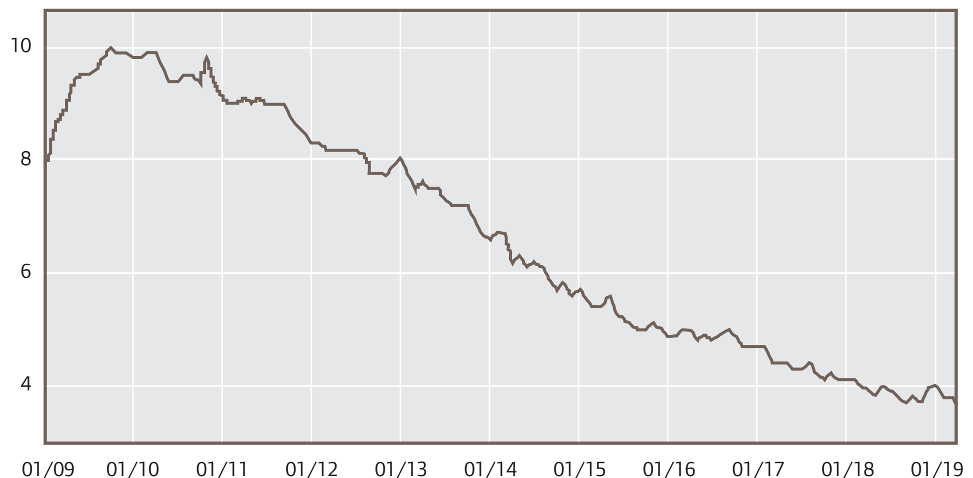
What Do the Indicators Suggest at Present?

Fundamental economic indicators paint a positive picture of the US economy

The direct measures of economic activity generally paint a positive picture of the US economy. During the first quarter of 2019, the economy grew at a rate of 3.2%, and the figures for the four quarters of 2018 were 2.2% (Q1), 4.2% (Q2), 3.4% (Q3), and 2.2% (Q4); moreover, productivity growth during 2018 was 2.4%, which was the highest level since 2010. Housing starts have plateaued recently, and even started to decline during the first part of 2019, which usually foretells a slowdown, but not necessarily a recession.

Unemployment has been falling robustly since reaching 10% in October 2009, including the period since President Donald Trump assumed office. In May 2019, it was 3.6%, which was the lowest level since the 1960s. Falling unemployment has been mirrored by rising wage growth, though earnings are yet to grow at the levels seen during the 15 years prior to the global financial crisis. This is partially due to the mass quitting of the workforce caused by the 2008 recession; even though unemployment is falling, people keep reentering the workforce, limiting wage growth.

US Unemployment Rate (2009-2019)



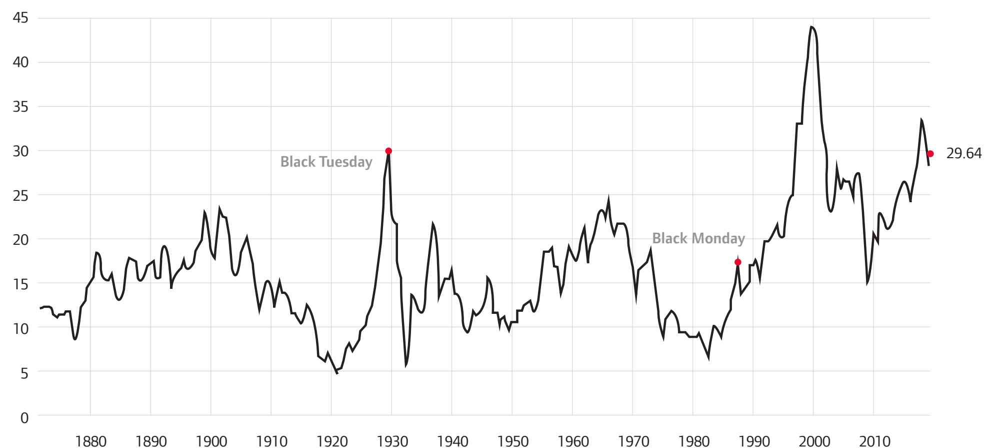
Corporate earnings grew at a very high rate (7.8%) during 2018, boosted by the Republican tax cut, and as the effects tapered out, analysts were expecting a decline in earnings during 2019. However, as corporate earnings data continue to arrive, most companies are beating estimates, and analysts are updating their forecasts to positive earnings growth for 2019.

What Do the Indicators Suggest at Present?

Assets are likely overvalued but the effect of a negative correction on the economy should be limited, due to lower levels of private debt and greater financial oversight.

In terms of asset prices, despite some tumult during the end of 2018, stock markets continue to perform well, and housing prices have been growing robustly since 2012. According to Shiller PE ratios, stocks are overvalued and due for a negative correction. However, due to the broad-ranging financial regulations enacted after the global financial crisis in 2008, the implications of a bursting bubble are not understood to be as grave as before – they are likely to cause slowing growth, rather than an actual recession. As an illustration, household debt as a percentage of GDP has been falling consistently since its peak in 2009. Corporate debt has been increasing, but total private debt as a percentage of GDP remains considerably below the levels seen prior to 2008.

Historical Shiller P/E Ratio



One of the more concerning signs has been the inverted yield curve for government bonds, which means that the yield on long bonds has fallen below that of short ones. The cause is investors buying long bonds, raising their value and causing their yield to fall, which is a sign of apprehension among investors about the future. Historically, this has been a very accurate – though not bulletproof – prediction of a recession in the coming two years. Since the initial inversion, the yield curve briefly un-inverted, a positive indicator that is complemented by direct sentiment measures; yet its shape continues to evolve and should be monitored closely.

What Do the Indicators Suggest at Present?

The biggest proximate threat to the economy is the US-China trade dispute.

Some analysts might draw attention to the fact that the current recession-free expansion (10 years) cannot go on forever, and that a recession must occur eventually. However, long periods of growth are possible: Australia has avoided a recession for the last 27 years, as did Japan for 30 years starting in the 1960s, and the Netherlands starting in the 1980s.

Based on the prevailing indicators, therefore, a recession seems unlikely, as does a significant slowdown. Anything from a moderate slowdown to continued growth appears to be the most likely outcome. Moreover, if a recession does occur, it is not likely to be caused by a financial bubble, due to the evolved nature of the relationship between the financial sector and the economy post-2008.

Instead, the most proximate threat to the economy is the trade war with China, and at the start of May 2019, President Donald Trump imposed new tariffs, which the Chinese responded to. Increasing tariffs will hurt US corporate earnings, as well retaliatory tariffs by China via their effect on US exports. The dispute stems from the US accusing China of unfair trade practices, including (but not limited to) de facto intellectual property theft in the form of forcing foreign companies to surrender technological trade secrets in exchange for access to the Chinese market. Trump's goal is to force China to reform its practices by undermining its exports, which have been the engine of its growth for several decades. That is why dialogue exists between both sides, and in the long run, since the US demands are quite reasonable, and the pain suffered by China is worse than that suffered by the US, it is more likely that the issue will be resolved rather than escalated.

The Role of Political Factors

President Donald Trump has a variety of political tools at his disposal to stimulate the economy over the course of the next two years, and his quest for a second term gives him a strong incentive to use them.

Policymakers can have profound effects on the level of aggregate economic activity via a variety of interventions, such as fiscal and monetary policy. These decisions are not made on purely technocratic grounds – they are sensitive to political considerations.

In the case of the US economy, there will be presidential elections in November 2020, and the performance of the economy during the election year is often an important determinant of whether or not voters will support the incumbent. President Donald Trump is aware of this, and he is therefore likely to use the political tools at his disposal to ensure that any recession is either avoided, or at the very least delayed until after 2020.

Note that his desire to secure a second term is likely to be more acute than that of a typical first-term president, because he needs the immunity afforded to him by being president to avoid legal sanctions after the conclusion of his presidency. Trump has clashed with various constituents during his first term, chief among them Democrats, who control the House of Representatives. Therefore, expect Trump to wield any tool at his disposal in an attempt to keep the economy buoyant until the conclusion of 2020.

The most likely courses of action include a tax cut by executive order (since the Democrat-controlled House of Representatives is likely to block a conventional bill) which targets the middle classes; and replacing the Chairman of the Federal Reserve, Jerome Powell, with a candidate who has been pre-screened to ensure that they will keep interest rates low, and may even cut them.

Trump could also accelerate efforts at resolving the China trade dispute. The political calculus on the Chinese side also works in Trump's favor, as China is facing the threat of a recession, creating a genuine desire to rapidly resolve the issue.

In principle, Trump could initiate an infrastructure spending bill as a form of fiscal stimulus. However, this is unlikely because it requires congressional support, and while the Democrats are keen on infrastructure spending, they differ sharply with Trump over how to fund such increased spending.

Epilogue: Long Term Perspectives

Western economies - including the US - will be challenged by pension liability issues in the long run, but the US may be comparatively better positioned to weather such headwinds

Though economic and political factors both suggest that a recession is highly unlikely during the next two years, the US economy – and all western economies – will face major problems during the next 10 to 20 years due to pension liabilities.

The post-World War 2 pension system in the USA depended on young working people funding the pension payouts of living retirees. This system works well when the birth rate is high, and when the retirement age is close to the age of death. Once the birth rate falls, the system becomes unsustainable, as the number of working young people in insufficient to cover the pensions of living retirees; and this problem is exacerbated by medical advancements that have prolonged the length of people's post-retirement lives.

Neither of these developments was foreseen by the creators of the pension system. As a result, in its 2019 report, the US Government Accountability Office cited a figure stating that the pension program will be insolvent by 2026 with a 99% probability.

The financially straightforward solutions to this problem are likely to cause great social tension: either allowing for high levels of immigration, or simply defaulting on obligations. Whatever course of action the government eventually pursues is likely to cause a sharp and potentially long recession. For now, this can be avoided with the issuing of further long-term debt, but the federal debt-to-GDP ratio in the USA is currently 105% and rising, meaning that the requisite recession cannot be averted for more than around 10 years.

Despite these challenges, the US is likely to remain a top investment destination, as it is the most important source of technological progress in the world. The US continues to attract the world's brightest minds in science and research as it boasts a vibrant and highly sophisticated higher education system that fits hand-in-glove with industry, and has capital markets with the depth necessary to transform cutting-edge science into successful commercial ventures. As global economies transform and become more tech-driven, we expect the US to continue maintain its pole position in this space. Moreover, the US may even see the gap between it and competitors widen rather than contract, for two reasons.

First, the demographic anomalies causing the problem in the US are present in all western economies, but in even more acute form. Countries such as Japan and Italy have highly distorted demographic profiles that have a very high likelihood of causing fiscal collapse.

Second, despite the current wave of anti-immigrant sentiment in the US, using immigration to address the problem is far more politically realistic in the US than in Europe, where population densities are already high, and the cultural aversion to immigrants is even higher than in the US. The US boasts a much richer history of multi-ethnic cohesion and immigration, making the option much more workable than in a country such as Japan or Spain.

Conclusion

In terms of its fundamentals, the US economy is performing well, making a recession during 2019-2020 unlikely. The likelihood of a recession is further diminished by the fact that President Donald Trump has both the ability and the desire to stimulate the economy in the run-up to the 2020 presidential elections. Though asset prices are overvalued, a correction is unlikely to drive the economy to a recession, as the exposure to the assets is lower. The biggest proximate threat to the economy is the Sino-American trade war.

Arcapita's US Investment Strategy

Real Estate

Arcapita's approach to US Real Estate investing is based on targeting property types that we believe have structural support from long-term economic and demographic trends as a mitigant to the possibility of future cyclical downturn.

US Industrial

We are optimistic about the prospects of the US industrial sector given the permanent shift over the past decade in how the US economy utilizes warehousing and distribution space, and the national tenant demand this has created that is now exceeding new supply due to the declining availability of sufficient land, and the measured availability of construction loans. We expect that future supply chain requirements, including the growth of e-commerce, will perpetuate these conditions into the foreseeable future.

US Rental and Student Housing

We also see continued demand for the broader US rental market and for student housing in particular. Changing household formation, and demographic, financial, and lifestyle trends translate into increased demand for all forms of US rental housing. In particular, properties proximate to employment centers and universities are benefitting from measurably higher demand from millennial and post-millennial cohorts.

Private Equity

Within our US Private Equity business, we look for companies first and foremost with high quality management teams but also business models and sectors or end markets that are inherently recession resistant. In addition, we typically use less leverage than what the market offers to further protect our downside in the case of a cyclical downturn.

Consumer

The consumer sector represents 70% of the US economy and contains opportunities with disruptive and attractive business models, including brands circumventing traditional channels by accessing consumers directly via e-commerce, and experiential retail which cannot be replaced by online marketplaces. The businesses we target typically have attractive variable cost structures and free cash flow generation which should enable us to easily scale down in the context of a cyclical downturn to maintain profitability and cash flow.

Transportation & Logistics

We see three general trends as driving long term growth: (i) growth in e-commerce, (ii) complexity in the supply chain which is increasingly global; and (iii) businesses outsourcing supply chain management. These general trends provide long term growth with an extremely sticky relationship with corporate customers by providing a mission critical service, giving us downside protection in a cyclical downturn.

Business Services

US businesses are increasingly outsourcing non-core activities and are required to rely on third party businesses to fill these needs. We seek attractive business models that provide mission critical services to corporations, deliver a consistently high quality service while generating measurable cost savings, and have high free cash flow generation.

Arcapita Overview

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia. Through a dedicated office in the US, Arcapita originates, executes and manages compelling alternative investment opportunities in the United States to serve an exclusive group of institutional and private investors.

Arcapita originates Shari'ah compliant alternative investments for its investors and shareholders. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region and Southeast Asia over the past two decades. With offices in Bahrain, Atlanta, London and Singapore, Arcapita's management team has completed over 80 transactions with a total value of approximately $30 billion and possesses a footprint to invest on a global scale. The business is defined by the quality of its people - a management team with extensive experience gained in all market conditions and a group of professionals with deep expertise in their areas of focus.

www.arcapita.com

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